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Consumption Versus Investment

Many people seem to believe economic growth can be divided into two parts: the short-run and the long-run. According to this view, the short-run is driven by consumption, and the long-run is driven by investment.

The Short-Run View

If consumers go shopping, business is good. If consumers stay home, business is bad. Thus, to stimulate the economy, all the government has to do is give people more money to spend. The problem with this view is that no one stops to ask, "Where does the money come from?"

The only way the government can give money to someone is by taking it from someone else – either in the form of taxes or borrowing.[1] This is a zero sum game in which one person's gain is another person's loss. Some economists try to obscure this fact by introducing a concept known as the "marginal propensity to consume." That's a fancy way of saying some people spend more of their income than others.

According to this concept, low-income people are more likely to spend an extra dollar than high-income people. Thus, taking money from the rich and giving it to the poor will stimulate demand and boost the economy in the short-run.

This view of the economy is flawed for several reasons. First, recent evidence from the 2001 tax cut suggests low-income people are just as likely to save an income tax rebate as high-income people.[2]

Second, consumer spending is already near record highs, personal saving is near record lows, and consumer debt is at its highest level ever. There is no reason to believe the government could – or should – increase consumer demand. (Chart #1 and Chart #2)

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[1] The government could print more money, but that would represent a change in monetary policy, not fiscal policy.

[2] "Did the 2001 Tax Rebate Stimulate Spending? Evidence from Taxpayer Surveys" Matthew Shapiro and Joel Slemrod, NBER Working Paper 8308, October 2002. http://www.nber.org/papers/w9308

Third, an increase in consumer demand does not automatically translate into more domestic production and investment. The demand might be met through increased imports. Or, the demand might not be met at all, in which case consumer prices would rise.

Finally, the belief that we need more consumption ignores the role of saving. When money is saved, it does not disappear. It goes into the financial markets where it is borrowed and <u>spent</u> on things like houses and cars, or factories and equipment.

The Long-Run View

Everyone agrees investment is the key to productivity and higher wages. However, some economists claim that during a recession, we have idle resources and unused capacity, so the money people save won't be borrowed and spent. Instead, it will just sit around gathering dust. But, that's nonsense.

We live in a diverse and dynamic economy. There are always opportunities for new investment. While some sectors are shrinking, others are expanding. This is evident from the fact that capacity utilization rates range from 90 percent in petroleum and coal products, to 50 percent in communication equipment.[3] Our financial markets are designed to direct the money we save into those areas that can make use of it.

The idle resources and unused capacity that exist in the communication sector, and elsewhere, are the result of overly optimistic assumptions about the demand for these specific goods and services. Government efforts to stimulate demand can neither force people to buy things they don't want, nor transform unwanted items into things people do want.

Realigning our economy in a manner consistent with ever changing demand takes time and money. Only by foregoing consumption, can we provide entrepreneurs with the funds they need to invest in the production of new goods and services.[4]

It is generally believed that the federal budget deficit has an adverse impact on saving and investment. When the deficit goes up, interest rates rise, and investment falls. But, the empirical data do not support this view. There is no consistent or statistically significant relationship between deficits, interest rates, and investment. (Chart #3)

To the extent such a relationship might exist, it's important to understand that all deficits are not created equal. A reduction in marginal income tax rates will increase the

[3] Federal Reserve Statistical Release, G.17, Industrial Production and Capacity Utilization, http://www.federalreserve.gov/releases/G17/Current/default.htm

[4] Spending more provides funds to existing businesses. But, saving more provides funds to new businesses.

after-tax rate of return on investment. A higher return will increase the supply of savings, thereby mitigating any potential impact of higher deficits.[5]

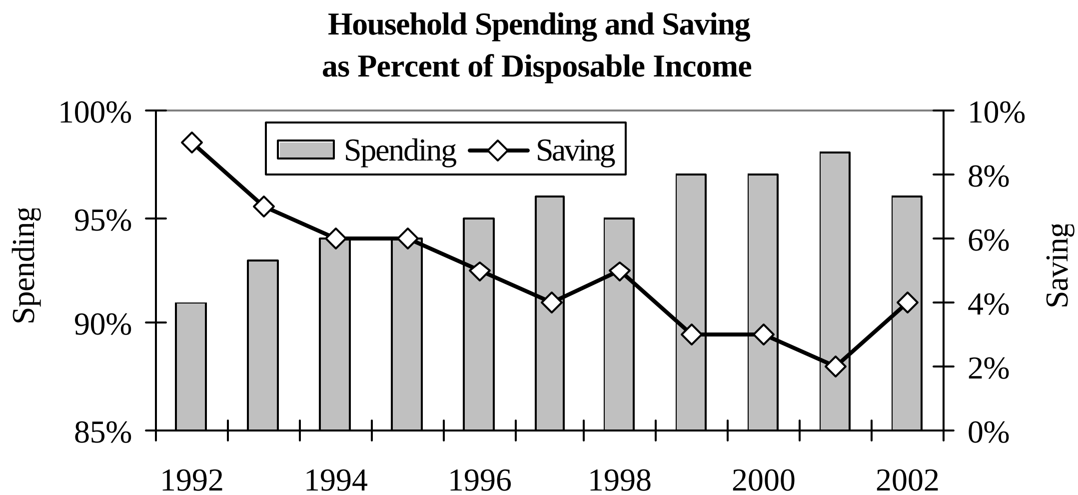
On the other hand, a higher deficit caused by more government spending would not have the same mitigating effects.

The recession that officially began in March of 2001, was proceeded by a significant decline in investment. Consumption has continued to rise throughout the period. (Chart #4)

Efforts to stimulate more consumption would only come at the expense of a much needed increase in saving and investment.

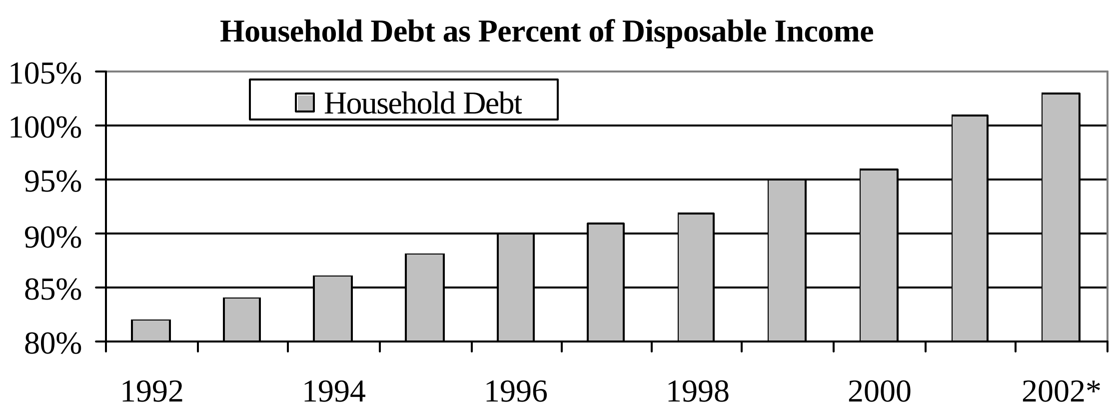
[5] Reducing the top income tax rate to 35 percent from 38.6 percent would increase after-tax returns by almost 6 percent for individuals in this bracket [(1-.35)/(1-.386)-1]

Chart #1



Source: Bureau of Economic Analysis

Chart #2



Source: Federal Reserve Board
*Through 3rd Quarter of 2002

Chart #3

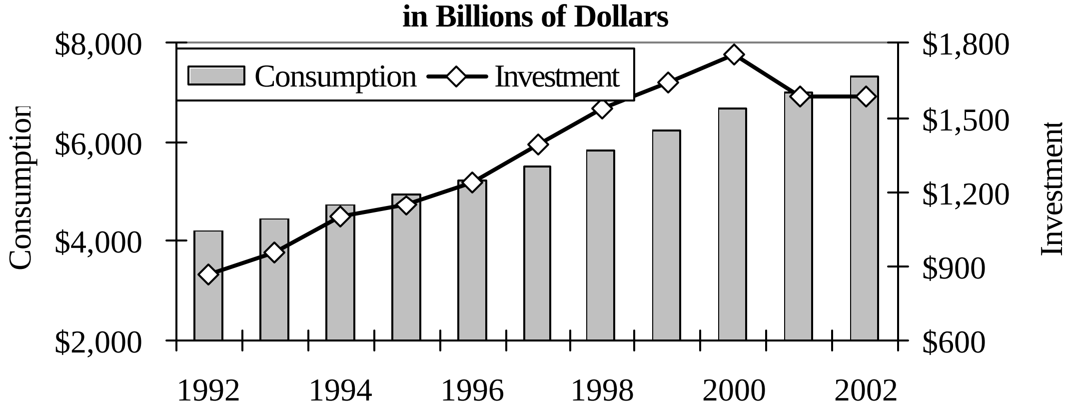
Correlation Between Deficits and Interest Rates 1952-2002

	Number of Observations	Average Change in Deficit (Percent of GDP)	Average Change in Interest Rate (Aaa Bonds)
Lower Deficit = Lower Interest *(Percent of Total)*	67 *(34%)*	-1.4%	-1.05%
Lower Deficit = Higher Interest *(Percent of Total)*	37 *(19%)*	-1.7%	1.36%
Higher Deficit = Lower Interest *(Percent of Total)*	42 *(21%)*	1.1%	-0.97%
Higher Deficit = Higher Interest *(Percent of Total)*	53 *(27%)*	2.1%	1.49%
Total Observations *(Percent of Total)*	199 *(100%)*		

Source: Federal Reserve Board

Chart #4

Personal Consumption and Gross Private Domestic Investment in Billions of Dollars



Source: Bureau of Economic Analysis